2017

MID-MARKET RISK INDEX

BY EQUIFAX CREDIT RATINGS

EQUIFAX

Equifax Credit Ratings

Since our last Mid-Market Risk Report was released in October 2016, we have witnessed Trumponomics, Brexit, Opec, the French election and, closer to home, the latest Australian Federal Budget announcement. These events have all added to the uncertainty and volatility of prospects for Australian businesses.

Last year, we highlighted how businesses had, in response to the aftermath of the credit crisis of 2007, focused on balance sheet repair and cost efficiencies.

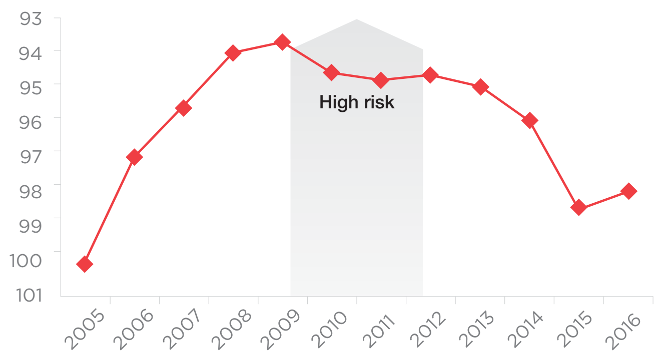
In 2017 the challenges are many. In particular, the risks to the residential construction segment is of particular interest. Sharp regulatory action to control the escalation in Australian residential housing prices is expected to take its toll over the medium term. The withdrawal of bank and foreign capital to the residential property investment segment are likely to have a meaningful effect on demand, asset prices and the fortunes of builders and developers leveraged to that sector.

The credit profiles of cyclicals such as mining have continued to soften whilst capital intensive industries such as manufacturing and construction are reverting to weaker credit quality.

Healthcare and transport have been the distinguished performers over the past few years. These sectors have benefited from increased demand and sound financial flexibility.

Regulatory tailwinds for healthcare are likely to underpin a further improvement in the sector's credit profile.

Turning Point



The 2017-2018 budget re-introduced indexation for certain items on the Medicare Benefits Schedule, injecting four billion dollars into the healthcare sector over the next four years. Another win for the sector is the indexing of diagnostic imaging services from 1 July 2020. Imaging services have not been indexed for over twelve years.

The transport sector continues to benefit from the tailwinds of low fuel prices and rising trade surplus. The trade-weighted index has readjusted to lower commodity prices making Australian exports more attractive. This bodes well for trade and, therefore, for freight transport.

Despite some industries observing an improvement in their sector rating index, the broader Australian mid-market remains susceptible to global impacts and many sectors continue to face ongoing headwinds contributing towards an overall decline in corporate resilience.

Index calculation and composition

The MMRI is an index of corporate credit ratings and credit scores assigned by Equifax Credit Ratings – an ASIC licenced, Australian domiciled Credit Rating Agency. The index value is based on an equally weighted mean of industry ratings. The industry ratings are an unweighted mean of the credit scores of businesses within that industry classification.

Key facts in calculation:	
Over 30,000	unique listed and private company credit ratings over the last ten years.
BBB+ to B-	The majority of credit ratings fall in the BBB+ to B- rating range.
Over 9,500	assessments per year (on average).

Picking the turning points in the credit cycle

The MMRI is a leading indicator of trends in external administration of Australian corporates. The index provides up to 12 months warning of turning points in the credit cycle.

The MMRI derives its predictive capacity from the breadth of coverage and rigour of the analysis of the underlying credit ratings. Credit ratings are forward-looking assessments of the risk of default. When industry risk, operating risk and financial risk factors deteriorate, credit ratings migrate lower indicating a heightened probability of default.

Construction

Outlook: Negative
Source of Risk: Regulatory action and the consequent withdrawal of capital from residential investment.

Revenue

Stable

Order books remain strong, but industry revenue growth is plateauing. In 2016, increased demand in residential and commercial construction masked a structural decline in engineering work – a result of the vacuum left by the resource boom. Construction output fell for six consecutive quarters to December 2016; Equifax expects activity to further recede over the next 18 months.

Profitability

Deteriorating

Pressure is mounting on margins from increasing competition – lower win rates and compromised pricing to win work, wage-related pressure from union activity, and union-sponsored project delays.

Liquidity

Stable

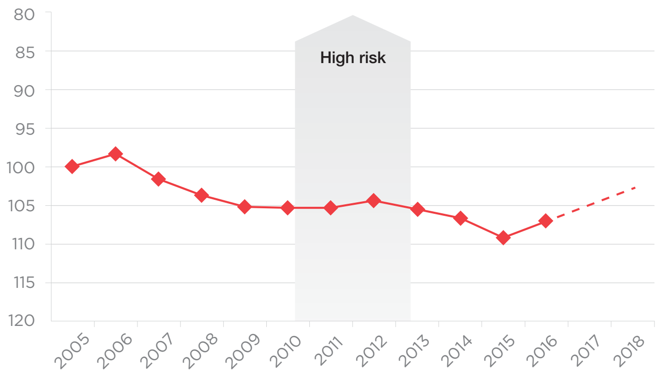
Liquidity is stable but not strong at a sector average of 1.5x. Reliance on creditors may put pressure on working capital in the event of a contraction in revenues.

Leverage

Deteriorating

The sector is well capitalised and has the financial flexibility to address an orderly slowdown in activity. Leverage may increase over the next 12 months as businesses in the sector transition their cost structures to an environment of lower profits and weaker order books.

Sector Rating Index – Construction



Like for Like % Change YOY

Median	2013	2014	2015	2016	Trend
Revenue	8%	2%	7%	7%	
EBITDA Margin	4%	-3%	5%	-1%	
EBIT Margin	5%	-4%	1%	3%	
Net Profit Margin	7%	-2%	-2%	4%	
Net Operating Cash	-12%	-25%	-35%	-40%	
Liquidity*	9%	4%	3%	1%	
Leverage^	-13%	-8%	-27%	-1%	

* Liquidity is Current Assets / Current Liabilities
^ Leverage is Gross Debt / EBITDA

Health Care and Social Assistance

Outlook: Positive
Source of confidence: Regulatory support, revenue growth and balance sheet optimisation.

Revenue

Improving

Consolidation of smaller service providers – leading to larger scale businesses, modest system growth and fiscal stimuli underpin the revenue recovery for the sector – highlighted in the previous release of the rating index. Changes to government incentives for bulk billing of diagnostic imaging (passed in the 2017 budget) will support revenue growth in calendar 2017.

Profitability

Stable

Margins contracted in 2016 due to a freeze on schedule fee indexation rates for most sub-segments and an intensification of price-based competition as larger consolidated businesses sought to increase market share and maximise their improved cost positions.

Cash Flow

Improving

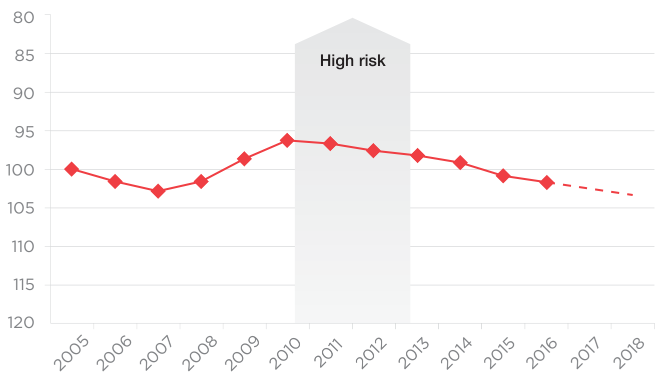
Operating cash flow was affected by the rapid decline in margins and investment in the cutting of long-run costs. Cash flows in the sector are expected to strengthen over the next 12 months as businesses reap the benefits of a lower cost base.

Leverage

Improving

Leverage improved in 2016; businesses rebalanced their capital mix – raising equity to pay down debt. This trend may continue over the next 12 months. Leverage in the sector is expected to return to long-run sustainable levels of 2.5x within the next three years (2016: 2.9x).

Sector Rating Index – Health Care and Social Assistance



Like for Like % Change YOY

Median	2013	2014	2015	2016	Trend
Revenue	6%	10%	9%	9%	
EBITDA Margin	6%	-3%	0%	-9%	
EBIT Margin	2%	3%	3%	-6%	
Net Profit Margin	13%	5%	-4%	-21%	
Net Operating Cash	12%	13%	0%	-11%	
Liquidity*	-1%	7%	-2%	-6%	
Leverage^	-11%	1%	8%	-7%	

* Liquidity is Current Assets / Current Liabilities
^ Leverage is Gross Debt / EBITDA

Manufacturing

Outlook: Stable

Source of confidence: Falling imports of capital goods and a cyclical low in the trade-weighted index are supportive of demand for locally manufactured goods.

Revenue

Deteriorating

Sector revenues are in structural decline. The exit of smaller – more vulnerable – businesses explains the rise in like-for-like revenue. The rebalancing in the domestic currency will be a tailwind for Australian manufacturing exports. Domestic consumption of light manufacturing goods is expected to moderate the decline in sector revenues in the short-term.

Margin

Deteriorating

Margin growth in the sector is muted. A high labour cost base, stagnating labour productivity and limited capital investment are contributing to structural weakness in the sector.

Liquidity

Stable

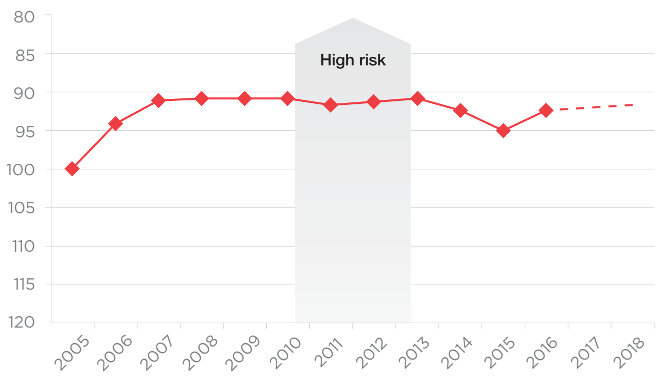
Liquidity in the sector is stable at approximately 2x. Greater discipline in product mix and pricing together with some much-needed investment in inventory management systems increased inventory rotation and released stagnant working capital.

Leverage

Stable

Limited capital replacement and investment, disciplined capital management and the absence of attractively priced corporate finance is expected to retain existing levels of leverage in the sector. Consolidation in the sector – especially in the automotive supply chain – has led to the rationalisation of production facilities and repayment of debt.

Sector Rating Index – Manufacturing



Like for Like % Change YOY

Median	2013	2014	2015	2016	Trend
Revenue	1%	4%	5%	7%	
EBITDA Margin	-2%	-5%	0%	1%	
EBIT Margin	-2%	-4%	-1%	1%	
Net Profit Margin	-4%	-7%	-1%	1%	
Net Operating Cash	-4%	-8%	10%	-2%	
Liquidity*	4%	3%	1%	1%	
Leverage^	2%	-8%	-11%	-5%	

* Liquidity is Current Assets / Current Liabilities

^ Leverage is Gross Debt / EBITDA

Mining

Outlook: Negative
Source of risk: Volatility of commodity demand and price is a risk to cash flows.

Revenue

Improving

Commodity production volumes increased in 2016 but prices remained weak until the second calendar half of 2016. This price recovery is not reflected in the fiscal 2016 results that comprise the majority of results reported to date. Higher prices of iron ore, coal and oil, from a temporary rebalancing of demand and supply, may provide the sector with respite over the short-term but this is expected to be temporary.

Profitability

Volatile

EBITDA margins of 20%-25% are representative of the sector and reflect the strong cost position of Australian resource companies. Aggressive cost cutting and insourcing have stemmed the threat to margins from positive operating leverage and the fall in commodity prices in fiscal 2016.

Liquidity

Improving

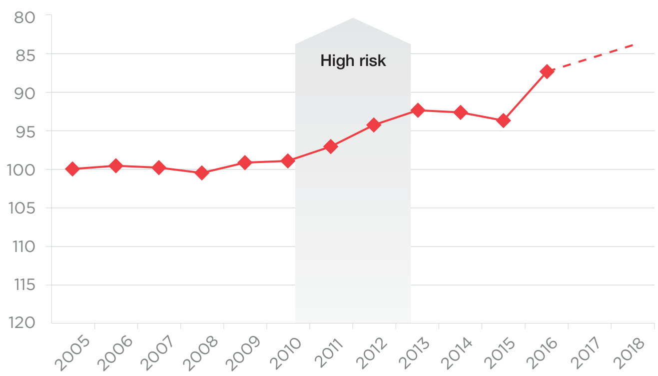
The liquidity position of the sector continued to strengthen in line with our expectations. Management focus on balance sheet repair in prior periods positively contributed to liquidity and supported businesses through the structural decline in commodity prices.

Leverage

Deteriorating

The financial flexibility of the sector deteriorated in FY16 as volume growth related capital expenditure met with weaker operating cash flows leading to an increase in sector leverage.

Sector Rating Index – Mining



Like for Like % Change YOY

Median	2013	2014	2015	2016	Trend
Revenue	0%	-5%	0%	-3%	
EBITDA Margin	-13%	-5%	9%	-6%	
EBIT Margin	-39%	-34%	-3%	-16%	
Net Profit Margin	-31%	-37%	0%	-21%	
Net Operating Cash	-13%	-13%	28%	-30%	
Liquidity*	12%	16%	18%	1%	
Leverage^	6%	-10%	-22%	43%	

* Liquidity is Current Assets / Current Liabilities
^ Leverage is Gross Debt / EBITDA

Transport

Outlook: Positive

Source of confidence: Growing trade surplus, low fuel prices and a cyclical low in the trade-weighted index are supportive of demand for freight transport.

Revenue

Stable

Revenue has stabilised against a backdrop of higher volumes of Australian commodity exports and increased domestic economic activity.

Profitability

Improving

The gradual repositioning of cost structures has supported the margins of the sector. Increasing throughput and supply volume adjustments resulted in greater capacity utilisation that will support margins over the next year.

Cash Flow

Improving

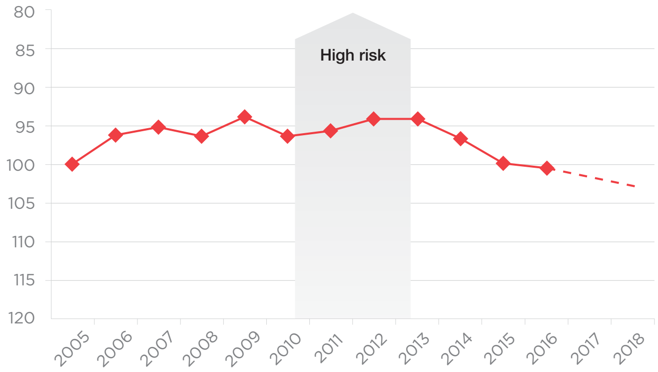
Better cash conversion and cash quality of earnings supported cash flows in the sector. Greater capacity utilisation offset some margin erosion.

Leverage

Improving

Leverage is continuing its cyclical decline with surplus operating cash and disciplined capital measures driving leverage down to a more sustainable long-term capital mix.

Sector Rating Index – Transport, Postal and Warehousing



Like for Like % Change YOY

Median	2013	2014	2015	2016	Trend
Revenue	5%	2%	2%	4%	
EBITDA Margin	7%	-3%	0%	-5%	
EBIT Margin	11%	-6%	-4%	-11%	
Net Profit Margin	12%	-7%	-3%	1%	
Net Operating Cash	20%	-12%	6%	11%	
Liquidity*	2%	1%	0%	0%	
Leverage^	-6%	5%	3%	-4%	

* Liquidity is Current Assets / Current Liabilities

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A tale of two economies

Weak commodity prices remain a drag on cash flows in WA and QLD

While the latest Mid-Market Risk Index reveals an overall decline in corporate financial health, it highlights the profound effect of weak commodity prices on the East and West Coast of Australia. On the eastern seaboard, businesses in New South Wales and Victoria demonstrate the strength of a buoyant construction sector whilst businesses in the West Australian economy persist in their struggle against weak iron ore prices. The Queensland economy has also benefited from construction and has also enjoyed a resurgence in coal prices and higher tourist inflows.

However weak commodity prices have reduced cash flows, particularly in the mining sector. This has caused a more uncertain outlook in Queensland and Western Australia, with mid market entities showing an overall decline in profitability, contributing towards a deterioration in the index.

Australia

VIC

Median - Growth	2013	2014	2015	2016	Trend
Revenue	2%	5%	5%	7%	
EBITDA Margin	-4%	-4%	0%	2%	
EBIT Margin	-7%	-8%	-2%	3%	
Net Profit Margin	-10%	-8%	-1%	5%	
Net Operating Cash	0%	-3%	2%	-1%	
Liquidity*	1%	4%	0%	-1%	
Leverage^	2%	5%	-5%	-7%	

WA

Median - Growth	2013	2014	2015	2016	Trend
Revenue	6%	0%	7%	-3%	
EBITDA Margin	-2%	-7%	-3%	-15%	
EBIT Margin	-9%	-5%	-5%	-31%	
Net Profit Margin	-7%	-13%	-2%	-36%	
Net Operating Cash	-5%	-9%	2%	-37%	
Liquidity*	10%	8%	4%	3%	
Leverage^	15%	-9%	-26%	15%	

NSW

Median - Growth	2013	2014	2015	2016	Trend
Revenue	3%	6%	7%	9%	
EBITDA Margin	1%	-6%	0%	3%	
EBIT Margin	-1%	-7%	3%	2%	
Net Profit Margin	0%	-6%	0%	1%	
Net Operating Cash	-3%	-9%	-5%	4%	
Liquidity*	4%	2%	2%	1%	
Leverage^	-8%	-2%	6%	-9%	

QLD

Median - Growth	2013	2014	2015	2016	Trend
Revenue	2%	3%	4%	10%	
EBITDA Margin	-1%	-9%	5%	2%	
EBIT Margin	-2%	-13%	1%	-2%	
Net Profit Margin	-2%	-18%	-2%	-2%	
Net Operating Cash	2%	-13%	12%	-13%	
Liquidity*	9%	3%	3%	2%	
Leverage^	-6%	25%	-21%	-2%	

* Liquidity is Current Assets / Current Liabilities
^ Leverage is Gross Debt / EBITDA

New Zealand

- The quality of corporate credit in New Zealand continues to deteriorate. Balance sheets are weak and margins are thin. The divergence of operating cash flows and revenue flag a fall in the quality of earnings that is also reflected by an increase in leverage.
- Strength in construction sector – supported by net positive migration, rising gross external debt and falling domestic savings rates has offset the adverse effects on trade related cash flows.
- In contrast to the fortunes of the construction sector, trade balances have been adversely affected by weakness in the dairy sector. The dairy sector is suffering from long-term lows in dairy prices. Dairy prices have recovered, somewhat, from these lows in the first calendar half of 2016, but prices remain volatile.
- So, much is riding on the continued support of positive net migration, investment in real-estate and domestic consumption. But, the financial position of the household sector is weak and mirrors that of the corporate sector.
- Debt laden household balance sheets and weak affordability metrics – supported by the availability of cheap finance – are not a sustainable source of economic growth.

NEW ZEALAND

Median - Growth	2014	2015	2016	Trend
Revenue	0%	4%	7%	
EBITDA Margin	7%	0%	-2%	
EBIT Margin	4%	0%	-1%	
Net Profit Margin	4%	-1%	1%	
Net Operating Cash	-10%	-7%	-27%	
Liquidity*	-1%	2%	0%	
Leverage^	-7%	-1%	8%	

* Liquidity is Current Assets / Current Liabilities
^ Leverage is Gross Debt / EBITDA

Why Equifax Credit Ratings?

Benefits for issuers

As leading mid-market experts, our Ratings capability will provide you with:

- lower cost of funding
- financial flexibility
- longer tenors, and access to covenant-lite issues

to help lock in low interest rates for refinancing and business growth.

Through our comprehensive coverage of conducting **more than 20,000 financial assessments annually** for Australian large and medium sized corporations, we have built unrivalled financial data assets to conduct **industry benchmarking and peer comparisons.**

Benefits for investors

For investors seeking higher yield opportunities in a low interest rate environment, we can provide you with:

- Access to financial information on mid market companies to help manage your investment risk
- Transparency to support investment diversification decisions
- Portfolio optimisation.

As a leading local provider of credit ratings in Australia, our **breadth of coverage and depth of analysis** will bring you the insights you can rely on when pricing for risk, as well as the **early warning indicators** you need to be aware of for portfolio optimisation.

About Us

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